

WILLIAM A. MUNDELL
CHAIRMAN
JIM IRVIN
COMMISSIONER
MARC SPITZER
COMMISSIONER



BRIAN C. McNEIL
EXECUTIVE SECRETARY

ARIZONA CORPORATION COMMISSION

DATE: November 6, 2002
DOCKET NOS: W-01303A-01-0983
TO ALL PARTIES:

Enclosed please find the recommendation of Administrative Law Judge Teena Wolfe. The recommendation has been filed in the form of an Opinion and Order on:

ARIZONA-AMERICAN WATER COMPANY, INC.
(WAIVER OF REQUIREMENTS OF A.A.C. R14-2-801, ET SEQ.)


Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and ten (10) copies of the exceptions with the Commission's Docket Control at the address listed below by **12:00 noon** on or before:

NOVEMBER 15, 2002

The enclosed is NOT an order of the Commission, but a recommendation of the Administrative Law Judge to the Commissioners. Consideration of this matter has tentatively been scheduled for the Commission's Working Session and Open Meeting to be held on:

NOVEMBER 19 AND 20, 2002

For more information, you may contact Docket Control at (602)542-3477 or the Hearing Division at (602)542-4250.


BRIAN C. McNEIL
EXECUTIVE SECRETARY

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 WILLIAM A. MUNDELL
CHAIRMAN

3 JIM IRVIN
COMMISSIONER

4 MARC SPITZER
COMMISSIONER

5
6 IN THE MATTER OF THE APPLICATION OF
7 ARIZONA-AMERICAN WATER COMPANY,
8 INC. FOR A LIMITED WAIVER OF THE
9 REQUIREMENTS OF A.A.C. R14-2-801, ET SEQ.,
10 AND CERTAIN RELATED RELIEF.

DOCKET NO. W-01303A-01-0983

DECISION NO. _____

OPINION AND ORDER

11 DATE OF HEARING: August 8, 2002

12 PLACE OF HEARING: Phoenix, Arizona

13 ADMINISTRATIVE LAW JUDGE: Teena Wolfe

14 APPEARANCES: Mr. Norman D. James and Mr. Jay L. Shapiro,
FENNEMORE CRAIG, on behalf of Applicant
Arizona-American Water Company; and

Ms. Janet Wagner, Attorney, Legal Division, on behalf
of the Arizona Corporation Commission's Utilities
Division Staff.

15 **BY THE COMMISSION:**

16 On December 17, 2001, Arizona-American Water Company, an Arizona corporation
17 ("Arizona-American"), filed an application with the Arizona Corporation Commission
18 ("Commission") requesting a Commission declaration that the Commission's Public Utility Holding
19 Companies and Affiliated Interests Rules, A.A.C. R14-2-801, *et seq.* ("Affiliated Interests Rules") do
20 not apply to the transaction described in the application, or alternatively, requesting a limited waiver
21 of the requirements of the Affiliated Interests Rules, solely with respect to the described transaction
22 ("Application"). The transaction described in the Application consists of the proposed merger of
23 Arizona-American's parent, American Water Works Company, Inc., a Delaware corporation
24 ("American Water Works") with a subsidiary of RWE AG ("RWE"), a company organized under the
25 laws of the Federal Republic of Germany. The described transaction includes the acquisition of
26 American Water Works' outstanding shares of stock.

27 On January 15, 2002, at the request of the Commission's Utilities Division Staff ("Staff"), the
28

1 Commission suspended the Application for a period of 120 days.

2 On April 22, 2002, Arizona-American filed an amendment to the Application to include a
3 Notice of Intent to Reorganize, pursuant to Section 803(A) of the Affiliated Interests Rules.¹ By its
4 Application and subsequent amendment, Arizona-American requests either: 1) a declaration that the
5 Commission lacks jurisdiction over the transaction; or 2) a waiver from the Affiliated Interests Rules
6 with respect to the proposed transaction pursuant to A.A.C. R14-2-806; or 3) approval of the
7 transaction as a reorganization of a holding company pursuant to A.A.C. R14-2-803.

8 On May 10, 2002, Staff requested that a hearing be held on this matter. Arizona-American
9 consented to the procedural dates proposed by Staff, and by Procedural Order dated May 14, 2002,
10 this matter was set for hearing.

11 Arizona-American provided public notice of the hearing as required by the May 14, 2002
12 Procedural Order. No requests for intervention were received.

13 A public hearing was held as scheduled on August 8, 2002, before a duly authorized
14 Administrative Law Judge of the Commission. Arizona-American and Staff appeared through
15 counsel and presented evidence. No members of the public appeared to provide public comment.
16 Following the hearing, on September 6, 2002, Arizona-American and Staff submitted closing briefs,
17 and the matter was taken under advisement.

18 **DISCUSSION**

19 **A. The Proposed Transaction**

20 The transaction underlying Arizona-American's Application is an agreement by American
21 Water Works with RWE and Thames Water Aqua Holdings GmbH, a wholly-owned subsidiary of
22 RWE ("Thames Holdings"). Pursuant to the agreement, all of American Water Works' issued and
23 outstanding common stock will be acquired by Thames Water Aqua U.S. Holdings, a recently formed
24 Delaware corporation and a wholly-owned subsidiary of Thames Holdings. Thames Water Aqua
25 U.S. Holdings will be an American holding company, serving as a single "umbrella" company under
26 which RWE plans to place all of its American water and wastewater assets. The acquisition of
27

28 ¹ Arizona-American states that its amendment of the Application to include the Notice of Reorganization should not be construed as a waiver of its right to seek alternative relief, as may be appropriate.

1 American Water Works' common stock will be accomplished by means of a merger in which Apollo
2 Acquisition Company, also a Delaware corporation controlled by Thames Holdings, will be merged
3 with and into American Water Works, with American Water Works surviving the merger as a wholly
4 owned subsidiary of Thames Water Aqua U.S. Holdings. In conjunction with the merger, Thames
5 Water Aqua U.S. Holdings will purchase all of the issued and outstanding shares of American Water
6 Works' common stock at \$46.00 per share. Shareholder approval was obtained at a special meeting
7 on January 17, 2002.

8 RWE, Germany's fifth largest industrial group, is an international multi-utility service
9 provider with its core businesses in electricity, water, gas, waste management and other utility-related
10 services.² Thames Holdings serves as a holding company for the water and wastewater operations
11 under the RWE corporate umbrella. As stated above, Thames Water Aqua U.S. Holdings has been
12 formed as the holding company for all of the water and wastewater operations in the United States.
13 RWE has delegated the management of its various water operations worldwide to Thames Water
14 PLC ("Thames Water"), a corporation organized under the laws of England and Wales and
15 headquartered in London, which will be a sister affiliate of Thames Water Aqua U.S. Holdings.
16 Thames Water is presently the third largest private water company in the world.³

17 Following the completion of the proposed transaction, American Water Works' shares of
18 common stock would no longer be publicly traded, but would be held by Thames Water Aqua U.S.
19 Holdings. American Water Works would remain in existence and become responsible for managing
20 the Americas region (North and South America) of Thames Water, and would continue to be
21 headquartered in Voorhees, New Jersey. Arizona-American would continue to be a wholly-owned
22 subsidiary of American Water Works.

23 Arizona-American asserts that as a result of the proposed transaction, Arizona-American's
24 local and regional management will not change, there will be no reduction in Arizona-American's

25
26 ² RWE has a business presence in more than 120 countries on six continents. RWE and its subsidiaries employ some
170,000 people, more than one-third of whom work outside of Germany, including more than 16,000 employees in the
United States.

27 ³ Thames Water provides drinking water and wastewater treatment services to over 43 million people worldwide,
28 including 12 million people in and around the City of London. In the United States, Thames Water has 880 employees
staffing operations or offices in Houston, Pittsburgh, Cincinnati, Westfield, New Jersey, and Puerto Rico.

1 local staffing, there will be no changes in Arizona-American's rates and charges for service, and
 2 Arizona-American's capital structure will not change. Arizona-American's witness testified that
 3 there will be no request to recover any acquisition premium or any other costs associated with the
 4 proposed transaction, and that the proposed transaction will not cause any additional layer of
 5 management overhead to be allocated to Arizona-American. In addition, Arizona-American asserts
 6 that there will not be any cross-subsidization of any affiliates, and any transactions between Arizona-
 7 American and any "affiliate," as such term is defined in A.A.C. R14-2-801, will continue to be
 8 subject to the Affiliated Interests Rules and other regulatory requirements of the Commission.

9 Arizona-American believes that the proposed transaction is likely to generate benefits for
 10 Arizona-American and its utility customers. Arizona-American states that in addition to potential
 11 reductions in the cost of capital, Thames Water's extensive experience in managing water and
 12 wastewater operations throughout the world, when combined with the existing expertise of American
 13 Water Works' management, should enhance the quality of service provided to Arizona-American
 14 utility customers. Arizona-American states in support of this assertion that Thames Water, which
 15 manages water operations on six continents, has considerable experience in operating water systems
 16 in regions where security has been a significant concern for decades, and that Thames Water has an
 17 outstanding track record in terms of the quality of utility service it provides. Arizona-American
 18 claims that American Water Works and its subsidiaries, including Arizona-American, will benefit by
 19 becoming a part of an organization with significant expertise, greater access to capital, and greater
 20 economies of scale.

21 **B. Conditions Proposed by Staff**

22 Staff has recommended approval of the transaction pursuant to A.A.C. R14-2-803, subject to
 23 the following fifteen conditions:

- 24
- 25 #1 Arizona-American shall not seek recovery of any excess of cost over book value
paid pursuant to the reorganization at any time in the future from this Commission.
 - 26 #2 Arizona-American shall not seek recovery of any costs associated with the
27 reorganization, including internal corporate costs, in any future Arizona rate
28 proceeding.

- 1 #3 Arizona-American and its affiliates shall provide their books and records, upon
2 request, in the Phoenix metropolitan area. Arizona-American and its affiliates
3 shall also provide access to their books and records where such documents are
4 maintained.
- 5 #4 Arizona-American shall not adjust any existing account amounts as a result of the
6 reorganization. Arizona-American may make normal accounting adjustments that
7 would have occurred absent the reorganization.
- 8 #5 In future rate proceedings filed after the effective date of the reorganization,
9 Arizona-American shall have the burden of demonstrating that any cost overhead
10 allocations and direct charges resulting from the reorganization including, but not
11 limited to, the addition of layers of management, are reasonable and provide a net
12 benefit to Arizona-American and/or its customers.
- 13 #6 Arizona-American shall not allow the reorganization to diminish local (Arizona)
14 staffing that would result in service degradation.
- 15 #7 Arizona-American shall not allow its quality of service to diminish, the number of
16 service complaints should not increase, the response time to service complaints
17 should not increase, and service interruptions should not increase as a result of the
18 reorganization.
- 19 #8 Arizona-American shall continue to maintain its business headquarters in Arizona
20 and fully operational local (Arizona) field offices, as appropriate to maintain the
21 quality of its service.
- 22 #9 If Arizona-American ever plans to share with affiliates, or other entities, any
23 information made available to Arizona-American solely by virtue of the
24 company/customer relationship, such as billing information and services received
25 by a customer, it shall notify the Commission at least 180 days in advance. Such
26 notice shall, at a minimum, identify the intended use of the information. Arizona-
27 American shall also, at the time of the filing of the 180-day notice, file a tariff
28 setting forth appropriate customer notification procedures to inform customers
about the sharing.
- #10 If Arizona-American ever shares any customer information with affiliates, or other
entities, it shall maintain accurate records of revenues earned as a result and make
those records available to Staff upon request with ten days' notice. For the
purposes of this condition and Condition Nine above, customer information that is
prohibited from disclosure does not include a customer's name, address or service
location, and telephone number.
- #11 Arizona-American shall not use any utility plant or other property, that is used or
necessary for the provision of utility service, for any unregulated activity unless
Arizona-American maintains appropriate books and record of account detailing the
nature of such unregulated activity and providing appropriate allocations between

activities relating to Arizona-American's provision of utility service and the unregulated activity. Arizona-American's books and records concerning all unregulated activities shall be subject to the Commission's review and shall be made available in the Phoenix metropolitan area or, at the Commission's request, where the records are maintained, on ten days' notice.

#12 Arizona-American shall maintain a minimum common equity ratio of 35 percent of total capital. Arizona-American's total capital is defined as common equity, preferred equity, and long-term debt. Arizona-American shall not make remittances or pay dividends to American Water Works unless Arizona-American's common equity is at least 35 percent of total capital. If Arizona-American's common equity falls to 30 percent of total capital, American Water Works shall provide a cash infusion of equity sufficient to bring Arizona-American's common equity ratio back to a minimum of 35 percent of total capital. Arizona-American shall not be prohibited from requesting that the foregoing equity percentages be decreased based on changes to capital markets or other conditions that make it prudent to alter Arizona-American's capital structure.

#13 The cost of debt issued after the closing date of the reorganization, for purposes of setting rates in Arizona-American's rate proceedings, filed within ten years from the effective date of the reorganization, shall reflect a rating of A- (S&P) / Baa1 (Moody's) or higher.

#14 Arizona-American and its affiliates agree that in future Commission proceedings, they shall not seek a higher cost of capital than that which Arizona-American would have been authorized as a stand-alone entity. Specifically, no capital financing costs (either debt or equity) should increase by virtue of the reorganization.

#15 Arizona-American shall refrain from filing any non-emergency rate increase requests for one year from the closing date of the reorganization; however, Arizona-American may file rate increase requests prior to the reorganization's closing date, and any such requests shall not be subject to the conditions set forth herein.

C. Conditions in Dispute

Arizona-American and Staff both stated at the hearing that the fifteen conditions recommended by Staff, that are set forth above, are the result of attempts by Arizona-American and Staff to resolve the parties' differences regarding the necessity of conditions on Commission approval of the proposed transaction. The parties are not in complete agreement on the language of Staff's recommended Conditions Five and Eight, and are in substantial disagreement on the substance of Conditions Three and Thirteen. Arizona-American believes that Staff's recommended Conditions Three and Thirteen are unnecessary.

1 1. Condition Three

2 In lieu of the Condition Three proposed by Staff, Arizona-American proposes a Condition
3 Three as follows:

4 (Arizona-American)

5 Three. Arizona-American and its affiliates will comply with R14-2-801, *et seq.*,
6 pertaining to affiliated interests, or seek Commission authorization for any
7 waivers thereof, including the provisions of R14-2-804 relating to the
8 transaction of business with and access to the books and records of any
 affiliate, including the production of records at Arizona-American's local
 business headquarters and elsewhere.

9 For purposes of comparison, Staff's proposed Condition Three is as follows:

10 (Staff)

11 Three. Arizona-American and its affiliates shall provide their books and records, upon
12 request, in the Phoenix metropolitan area. Arizona-American and its affiliates
 shall also provide access to their books and records where such documents are
 maintained.

13 Arizona-American believes that the language Staff proposes for Condition Three goes beyond
14 what is already required under the Affiliated Interests Rules. Arizona-American believes there is no
15 reason to grant Staff *carte blanche* to examine the books and records of all RWE affiliates throughout
16 the world, without regard to whether that affiliate has business dealings with Arizona-American.
17 Arizona-American states that it is already prohibited, by A.A.C. R14-2-804(B), from transacting any
18 business with an affiliate "unless the affiliate agrees to provide the Commission access to the books
19 and records of the affiliate to the degree required to fully audit, examine or otherwise investigate
20 transactions between the public utility and the affiliate." Arizona-American believes that the
21 Commission may only regulate transactions between public utilities and their affiliates.

22 Staff argues that Arizona-American's proposal is not sufficient because it does not cover the
23 other possible situations in which Staff may need access to the books and records of one of the
24 Company's affiliates. Staff believes that there might be a need to look at the books and records of an
25 affiliate that doesn't do business directly with Arizona-American, because Staff might perceive that
26 the affiliate is causing costs to fall unfairly on Arizona-American's ratepayers.

27 We believe that, without provision of affiliate books and records to the Commission for
28

1 review, upon request, the Commission has no means of verifying whether transactions between a
 2 regulated public utility and its affiliate have occurred, and of thereby assessing possible ratemaking
 3 effects. The public interest requires that the Commission have access to such information. As Staff
 4 points out, Arizona-American's proposed Condition Three fails to recognize that the Commission's
 5 ratemaking authority extends beyond the requirements of the Affiliated Interests Rules. The
 6 Commission's constitutional ratemaking authority allows it to obtain information about a public
 7 service corporation's affiliates in order to be prepared to take action to prevent any negative
 8 consequences of intercompany transactions significantly affecting a public service corporation's
 9 structure or capitalization. This authority includes requiring access to a utility affiliate's books and
 10 records when such access is necessary for effective ratemaking. As a condition of approval of the
 11 proposed transaction, Arizona-American should be required to abide by Condition Three as proposed
 12 by Staff.

13 2. Condition Five

14 Staff proposes Condition Five as follows:

15 Five. In future rate proceedings filed after the effective date of the reorganization,
 16 Arizona-American shall have the burden of demonstrating that any cost overhead
 17 allocations and direct charges resulting from the reorganization including, but not
 18 limited to, the addition of layers of management, are reasonable and provide a net
 benefit to Arizona-American and/or its customers.

19 Arizona-American has stated that it is willing to accept Condition Five based on its
 20 understanding that the term "net" is intended to indicate only that Arizona-American must benefit in
 21 some respect from the service being provided, without a quantifiable dollar amount being associated
 22 with the benefit. Staff believes, however, that the crucial question is whether the cost of a transaction
 23 is reasonable in relation to the benefit to Arizona-American and its customers. Staff believes that the
 24 term "net" implies a comparison, though not necessarily a numerical one. Both Arizona-American
 25 and Staff agree that a benefit must be shown. We believe that in the future rate proceedings referred
 26 to in this condition, in order for Arizona-American to recover any cost overhead allocations and
 27 direct charges resulting from the reorganization, Arizona-American should have the burden of
 28 demonstrating that such costs are reasonable in relation to the benefits conferred on Arizona-

1 American and its customers. We find that no change to the language recommended by Staff is
2 required.

3 3. Condition Eight

4 Staff proposes Condition Eight as follows:

5 Eight. Arizona-American shall continue to maintain its business headquarters in Arizona
6 and fully operational local (Arizona) field offices, as appropriate to maintain the
7 quality of its service.

8 Arizona-American proposed at the hearing that a second sentence be added to Condition
9 Eight, as follows: "However, Arizona-American is not precluded from making local operational
10 changes in connection with integrating the water and wastewater systems acquired from Citizens
11 Communications and any future acquisitions into Arizona-American's local operations." Staff stated
12 at the hearing that elimination of the second sentence did not affect the meaning of Condition Eight.
13 Arizona-American believes that Staff's testimony at the hearing clarified that the second sentence is
14 not necessary to allow Arizona-American to make operational changes in connection with integrating
15 the water and wastewater systems acquired from Citizens earlier this year, or other operational
16 changes that relate to the provision of local services and are unconnected to the reorganization.
17 Arizona-American states that it can agree to Condition Eight, based on Staff's testimony. We agree
18 that the language of the first sentence does not preclude Arizona-American from making such
19 changes, and will adopt the language of Condition Eight as recommended by Staff.

20 4. Condition Thirteen

21 Staff proposes Condition Thirteen as follows:

22 Thirteen. The cost of debt issued after the closing date of the reorganization, for purposes of
23 setting rates in Arizona-American's rate proceedings, filed within ten years from
24 the effective date of the reorganization, shall reflect a rating of A- (S&P) / Baa1
(Moody's) or higher.

25 Arizona-American proposes that Condition Thirteen remain in effect for a period of three
26 years, as opposed to the ten year period proposed by Staff.

27 Arizona-American objects to this condition because credit ratings involve subjective
28 determinations made by investment services. Arizona-American states that its credit rating may be

1 affected by changes in regulatory requirements or other factors affecting the water utility industry or
2 the economy generally, regardless of the business activities of RWE or its subsidiaries. Arizona-
3 American therefore believes that Arizona-American should not be required to guarantee a minimum
4 debt cost. In addition, Arizona-American states that Condition 13 could weaken it financially and
5 lead to more frequent rate increase applications to maintain cash flows and debt service coverages.
6 Further, Arizona-American believes that its acceptance of Condition Fourteen eliminates the
7 possibility that an adverse credit rating will cause Arizona-American's cost of debt in a future rate
8 proceeding to exceed the market cost of debt for a business organization comparable to Arizona-
9 American.⁴

10 Staff states that although Arizona-American has suggested that the proposed transaction may
11 benefit Arizona-American by lowering its cost of capital, such a benefit cannot be quantified and may
12 not materialize, so Staff proposed Condition Thirteen to address the issue. Staff argues that
13 Condition 13 is necessary to protect ratepayers from the potential of increased rates due to any
14 possible downgrading in Arizona-American or its affiliates' bond ratings, and that its proposed ten-
15 year protection period is a relevant time frame that provides better protection to Arizona ratepayers
16 than Arizona-American's proposal of three years.

17 We agree with Staff that Condition 13 as proposed by Staff is appropriate and necessary as a
18 condition of approval of the transaction proposed by the Application, and will adopt Staff's proposed
19 time frame of ten years.

20 **D. Conclusion**

21 Staff and Arizona-American agree that as a result of the proposed transaction, Arizona-
22 American may benefit from the lower cost of capital that RWE enjoys as compared to that of
23 Arizona-American's affiliate, American Water Capital Corp., which currently provides debt capital to
24
25

26 ⁴ Staff proposes Condition Fourteen as follows:

27 Fourteen. Arizona-American and its affiliates agree that in future Commission proceedings, they shall not
28 seek a higher cost of capital than that which Arizona-American would have been authorized as a stand-
alone entity. Specifically, no capital financing costs (either debt or equity) should increase by virtue of the
reorganization.

1 Arizona-American through its parent, American Water Works. Because RWE's credit ratings are
 2 superior to those of American Water Capital Corp. at the present time, and RWE has a substantially
 3 larger market capitalization than that available to Arizona-American through American Water Works
 4 and American Water Capital Corp., RWE currently has greater equity and debt financing capability
 5 than American Water Works and American Water Capital Corp.

6 Precise quantification of benefits to Arizona-American resulting from RWE's lower cost of
 7 capital is difficult, however, due to factors such as the maturity dates of existing debt, uncertainty
 8 concerning future levels of capital expenditures and associated financing requirements, and changes
 9 in interest rates and potential future changes in credit ratings. Utility rates can be impacted by
 10 holding company structure and capitalization, and we believe that utility ratepayers should not be
 11 required to bear the burden of financial risk resulting from holding company diversification.
 12 Understanding this, Staff has proposed fifteen conditions that it recommends we place upon our
 13 approval of the transaction. Staff believes its proposed conditions will provide Arizona-American's
 14 ratepayers with protection from the possible adverse effects of the reorganization. Arizona-American
 15 disagrees with certain of those conditions. We believe, however, that the public interest requires that
 16 the Commission apply the Affiliated Interests Rules in a manner that will maximize protection to
 17 ratepayers, and for the reasons stated above, we believe that approval of the transaction proposed in
 18 the application should be made subject to the conditions as proposed by Staff.
 19
 20

21 * * * * * * * * *

22 Having considered the entire record herein and being fully advised in the premises, the
 23 Commission finds, concludes, and orders that:

24 **FINDINGS OF FACT**

25 1. Arizona-American is an Arizona corporation that has provided water utility service in
 26 portions of the Town of Paradise Valley, the City of Scottsdale and certain unincorporated portions of
 27
 28

1 Maricopa County for many years.⁵

2 2. All of Arizona-American's common stock was purchased by American Water Works
3 in the late 1960s. Since that time, Arizona-American has been a wholly-owned subsidiary of
4 American Water Works.

5 3. American Water Works is a Delaware corporation with headquarters located in
6 Voorhees, New Jersey. American Water Works is a publicly-traded company, whose shares of
7 common stock are traded on the New York Stock Exchange.⁶

8 4. In January 2002, Arizona-American completed the acquisition of the water and
9 wastewater utility systems and assets of Citizens Communications Company in Arizona. As a result
10 of that transaction, approved by the Commission in Decision No. 63584 (April 4, 2001), Arizona-
11 American currently provides water and wastewater service to approximately 140,000 customers in
12 Arizona. Consequently, Arizona-American is a Class A water utility, and is subject to the
13 Commission's Affiliated Interests Rules.
14

15 5. On September 16, 2001, American Water Works entered an agreement with RWE to
16 merge with one of RWE's subsidiaries. On January 17, 2002, at a special meeting, American Water
17 Works' shareholders approved Thames Water Aqua U.S. Holdings' purchase of all of the issued and
18 outstanding shares of American Water Works' common stock at \$46.00 per share, in conjunction
19 with the merger.
20

21 6. On December 17, 2001, Arizona-American filed the Application with the
22 Commission.
23

24 7. On January 15, 2002, at the request of Staff, the Commission issued Decision No.
25

26 ⁵ Arizona-American was originally named Paradise Valley Water Company. The Company's name was changed to
Arizona-American Water Company in January 2000.

27 ⁶ At present, there are approximately 100 million shares of American Water Works common stock issued and outstanding.
28 American Water Works has more than 60 subsidiaries (both regulated and unregulated), which collectively have a
business presence in 27 states and 3 Canadian provinces.

64362, which suspended the Application for a period of 120 days.

8. On April 22, 2002, Arizona-American filed an amendment to the Application that contained the information required for a notice of intent to reorganize pursuant to A.A.C. R14-2-803(A). By its Application and the subsequent amendment, Arizona-American requests either: 1) a declaration that the Commission lacks jurisdiction over the transaction; or 2) a waiver from the Affiliated Interests Rules with respect to the proposed transaction pursuant to A.A.C. R14-2-806; or 3) approval of the transaction as a reorganization of a holding company pursuant to A.A.C. R14-2-803.

9. On May 10, 2002, Staff filed a Request for Procedural Order, requesting that deadlines be established for the filing of written testimony, the commencement of the hearing and certain other procedural matters. Arizona-American consented to the dates proposed by Staff.

10. The Commission issued a Procedural Order on May 14, 2002, setting this matter for hearing on August 8, 2002, and establishing the agreed-upon procedural deadlines.

11. On July 11, 2002, Arizona-American caused public notice of the hearing to be published in The Arizona Republic, a newspaper of general circulation within the State of Arizona.

12. The Commission received no intervention requests.

13. A public hearing was held on the Application on August 8, 2002. Arizona-American and Staff appeared through counsel and presented evidence. No persons appeared to provide public comment at the hearing.

14. Written public comments that advocated a thorough review of the application were filed in the docket on September 3, 2002.

15. The parties filed closing briefs on September 6, 2002.

16. The transaction described in the discussion above would result in a holding company structure that can be summarized as follows:

1 RWE AG, a company organized under the laws of the Federal Republic of Germany

2 Thames Water Aqua Holdings GmbH, a holding company
3 organized under the laws of the Federal Republic of Germany
4 (wholly-owned by RWE AG)

5 Thames Water Aqua U.S. Holdings, a Delaware Corporation
6 (wholly-owned by Thames Water Aqua Holdings GmbH)

7 American Water Works Company, Inc., a Delaware Corporation
8 (wholly-owned by Thames Water Aqua U.S. Holdings)

9 Arizona-American Water Company, Inc., an Arizona Corporation
10 (wholly-owned by American Water Works Company, Inc.)

11 17. American Water Capital Corp. ("AWCC"), another American Water Works
12 subsidiary, currently provides debt capital and financial management services to American Water
13 Works and its utility subsidiaries, including Arizona-American.

14 18. Both Staff and Arizona-American agree that Arizona-American may benefit from the
15 lower cost of capital that RWE enjoys as compared to AWCC. RWE's credit ratings are superior to
16 those of AWCC at the present time, and RWE has a substantially larger market capitalization than
17 that available to Arizona-American through American Water Works and AWCC. RWE therefore has
18 greater equity and debt financing capability than American Water Works and AWCC. RWE also has
19 access to the European capital market as well as the United States domestic market.

20 19. Precise quantification of benefits to Arizona-American resulting from RWE's lower
21 cost of capital is difficult, due to factors such as the maturity dates of existing debt, uncertainty
22 concerning future levels of capital expenditures and associated financing requirements, and changes
23 in interest rates and potential future changes in credit ratings.

24 20. The credit rating of a parent company can positively impact the cost of capital of a
25 utility affiliate, but it can also negatively impact it. If RWE's ratings were to fall in the future, the
26 positive benefits that Arizona-American anticipates could fail to materialize and be replaced by
27

negative ones.

21. Staff recommends that the Commission condition the approval of this transaction upon the following fifteen conditions:

- #1 Arizona-American shall not seek recovery of any excess of cost over book value paid pursuant to the reorganization at any time in the future from this Commission.
- #2 Arizona-American shall not seek recovery of any costs associated with the reorganization, including internal corporate costs, in any future Arizona rate proceeding.
- #3 Arizona-American and its affiliates shall provide their books and records, upon request, in the Phoenix metropolitan area. Arizona-American and its affiliates shall also provide access to their books and records where such documents are maintained.
- #4 Arizona-American shall not adjust any existing account amounts as a result of the reorganization. Arizona-American may make normal accounting adjustments that would have occurred absent the reorganization.
- #5 In future rate proceedings filed after the effective date of the reorganization, Arizona-American shall have the burden of demonstrating that any cost overhead allocations and direct charges resulting from the reorganization including, but not limited to, the addition of layers of management, are reasonable and provide a net benefit to Arizona-American and/or its customers.
- #6 Arizona-American shall not allow the reorganization to diminish local (Arizona) staffing that would result in service degradation.
- #7 Arizona-American shall not allow its quality of service to diminish, the number of service complaints should not increase, the response time to service complaints should not increase, and service interruptions should not increase as a result of the reorganization.
- #8 Arizona-American shall continue to maintain its business headquarters in Arizona and fully operational local (Arizona) field offices, as appropriate to maintain the quality of its service.
- #9 If Arizona-American ever plans to share with affiliates, or other entities, any information made available to Arizona-American solely by virtue of the company/customer relationship, such as billing information and services received by a customer, it shall notify the Commission at least 180 days in advance. Such notice shall, at a minimum, identify the intended use of the information. Arizona-American shall also, at the time of the filing of the 180-day notice, file a tariff

1 setting forth appropriate customer notification procedures to inform customers
2 about the sharing.

3 #10 If Arizona-American ever shares any customer information with affiliates, or other
4 entities, it shall maintain accurate records of revenues earned as a result and make
5 those records available to Staff upon request with ten days' notice. For the
6 purposes of this condition and Condition Nine above, customer information that is
7 prohibited from disclosure does not include a customer's name, address or service
8 location, and telephone number.

9 #11 Arizona-American shall not use any utility plant or other property, that is used or
10 necessary for the provision of utility service, for any unregulated activity unless
11 Arizona-American maintains appropriate books and record of account detailing the
12 nature of such unregulated activity and providing appropriate allocations between
13 activities relating to Arizona-American's provision of utility service and the
14 unregulated activity. Arizona-American's books and records concerning all
15 unregulated activities shall be subject to the Commission's review and shall be
16 made available in the Phoenix metropolitan area or, at the Commission's request,
17 where the records are maintained, on ten days' notice.

18 #12 Arizona-American shall maintain a minimum common equity ratio of 35 percent
19 of total capital. Arizona-American's total capital is defined as common equity,
20 preferred equity, and long-term debt. Arizona-American shall not make
21 remittances or pay dividends to American Water Works unless Arizona-
22 American's common equity is at least 35 percent of total capital. If Arizona-
23 American's common equity falls to 30 percent of total capital, American Water
24 Works shall provide a cash infusion of equity sufficient to bring Arizona-
25 American's common equity ratio back to a minimum of 35 percent of total capital.
26 Arizona-American shall not be prohibited from requesting that the foregoing
27 equity percentages be decreased based on changes to capital markets or other
28 conditions that make it prudent to alter Arizona-American's capital structure.

#13 The cost of debt issued after the closing date of the reorganization, for purposes of
setting rates in Arizona-American's rate proceedings, filed within ten years from
the effective date of the reorganization, shall reflect a rating of A- (S&P) / Baa1
(Moody's) or higher.

#14 Arizona-American and its affiliates agree that in future Commission proceedings,
they shall not seek a higher cost of capital than that which Arizona-American
would have been authorized as a stand-alone entity. Specifically, no capital
financing costs (either debt or equity) should increase by virtue of the
reorganization.

#15 Arizona-American shall refrain from filing any non-emergency rate increase
requests for one year from the closing date of the reorganization; however,
Arizona-American may file rate increase requests prior to the reorganization's
closing date, and any such requests shall not be subject to the conditions set forth
herein.

22. Arizona-American proposes that the Commission adopt its version of Condition #3 and Condition # 13 as, opposed to Staff's version.

23. For the reasons set forth herein, it is in the public interest to attach the conditions as proposed by Staff to Commission approval of the transaction proposed in the Application.

CONCLUSIONS OF LAW

1. Arizona-American is a public service corporation within the meaning of Article 15, Section 3 of the Arizona Constitution and Title 40 of the Arizona Revised Statutes.

2. The Commission has jurisdiction over the transaction proposed in the Application pursuant to Article 15, Section 3 of the Arizona Constitution and the Commission's Affiliated Interests Rules, A.A.C. R14-2-801 through -806.

3. It is not in the public interest to grant Arizona-American's request for a waiver from Commission review of the proposed transaction.

4. The public interest requires that the Commission apply the Affiliated Interests Rules in a manner that will maximize protection to ratepayers.

5. Utility rates can be impacted by holding company structure and capitalization.

6. Utility ratepayers should not be required to bear the burden of financial risk resulting from holding company diversification.

7. Approval of the transaction proposed in the Application would serve the public interest only if conditions are imposed to provide adequate protection to ratepayers.

8. The public interest requires that the transaction proposed in the Application be approved, subject to the conditions as recommended by Staff, set forth in Findings of Fact No. 21 above.

ORDER

IT IS THEREFORE ORDERED that Arizona-American Water Company's request for a waiver from Commission review of the transaction proposed in the Application, pursuant to A.A.C. R14-2-806, is hereby denied.

...

...

1 IT IS FURTHER ORDERED that the transaction proposed by Arizona-American Water
2 Company in the Application is hereby approved, as a reorganization of a holding company pursuant
3 to A.A.C. R14-2-803, subject to the conditions recommended by Staff as set forth in Findings of Fact
4 No. 21 above.

5 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

6 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

7
8
9 CHAIRMAN

COMMISSIONER

COMMISSIONER

10
11 IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive
12 Secretary of the Arizona Corporation Commission, have
13 hereunto set my hand and caused the official seal of the
14 Commission to be affixed at the Capitol, in the City of Phoenix,
15 this ____ day of _____, 2002.

16
17 _____
18 BRIAN C. McNEIL
19 EXECUTIVE SECRETARY

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1 SERVICE LIST FOR: ARIZONA-AMERICAN WATER COMPANY, INC.

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